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As I see

THE FACTORS WHICH WILL END THE BOOM

LAST week a man called me on the phone and accused me of having caused him to lose $5,000. It seems that he had been transferred to St. Louis from Cleveland, Ohio. I recently spoke in Cleveland and expressed the opinion that the values of existing properties, particularly older properties, had passed the peak and would continue to drop for the next five or six years. He told me that the effect of my talk was to demoralize the market so completely that the best offer he was able to get for his house was $5,000 less than he could have gotten before my speech was made.

I answered him in this fashion:

1. I doubted very seriously whether my talk, even though it had been sponsored by one of the leading financial institutions in Ohio, would sufficiently affect public opinion to bring about a decrease of this amount.

2. If I was wrong in my assumption that the values of older properties would continue to decline, it would not take the market very long to recover from the shock I had given it. No one person and no group of persons can control the trend of prices. I will admit that an optimistic or a pessimistic opinion on the stock market, on real estate, or on any commodity, if given sufficient publicity, may cause an almost immediate effect, but in all cases this effect has been short-lived unless the opinion was substantiated and strengthened by subsequent events. My advice to this individual was that if he thought I was mistaken it would be wise for him to take his property off the market until an upturn occurred, with the probability that the upturn would at least restore the loss and would probably more than restore it. There is a tendency, I think, in all economic data if depressed without sufficient reason to not only regain the level that was left but to go above it for a short time.

3. If I was right in my analysis of the situation, the broadcasting of my opinion again could have only a temporary effect in accelerating slightly trends that would otherwise develop unheralded. Under these circumstances I would advise selling the property probably not in the next few weeks, but certainly in the next few months as progressive deterioration in values would otherwise eat further into the price he could get.

The path of a real estate analyst is often quite rugged and uninviting. In periods like the present the way to "make friends and influence people" is not generally the prediction of receding prices with eventually rising foreclosures.

I think it is inevitable that a person in my present position should give a great deal of thought to the fundamental bases of his opinions. Naturally, I do not like to be the cause of financial losses, either real or imaginary. I am, therefore, attempting in the following pages to give a resume of my present opinions with the reasons I have for them.

The real estate boom through which we have just come was caused primarily by a combination of the following factors.

1. The small amount of building during the period of the thirties.

2. The retardation of the marriage rate during the depression, resulting in a much lower rate of family formation than would have normally been the case. This resulted in a shrinkage in the number of families during the depression with a fairly heavy vacancy in dwelling units. As the depression was followed by the war boom, the increased prosperity resulted in a marriage rate far higher than the average, with a rapid rate of family formation and a very rapid shrinkage in vacancy.

3. A continuation of the long-term trend from the farms to the cities, a trend which has been operating since the first census was made in the United States about 150 years ago, but which was sharply accelerated by war production in the cities.

4. The increase in construction costs, which gave existing properties a higher value because of the greater cost of replacing them.

5. A decrease in interest rates brought about by government action, which had the indirect effect of decreasing capitalization rates and, therefore, increasing capitalized value.

6. The freezing of rentals at a low level at a time when incomes were rising rapidly. This kept housing costs low for a large percentage of the population, and as incomes rose the percentage spent for housing cost was constantly reduced. This resulted in many persons stepping up their standards of living, particularly insofar as housing went, and we ended up the period with a larger number of square feet used per person than we had been accustomed to in a free market. The inadequate return which owners received from their properties forced many of these owners to sell rental properties to persons needing shelter and these properties were withdrawn from the rental market.

7. The FHA and the Veterans Administration through government guarantees against mortgage losses encouraged heavy percentage loans amortized over a long period of years. This made it possible for persons to buy dwellings with extremely low down payments and greatly expanded the market.

As a result of the foregoing factors and many others, the market price of many older residential properties doubled and tripled and the cost of building a new building increased by 1-1/2 times in comparison with the cost in 1939 when the war started in Europe. It seems to me at the present time, however, that many of these factors which were responsible for the rapid rise in real estate prices are no longer exerting an inflationary pressure. Let us look at these factors again from the standpoint of their present influence on real estate prices:

1. The very low level of building during the thirties has been replaced by boom levels which surpassed in 1948 all previous years, with the exception of 1925. While 1949 will probably show some drop from the level of 1948, it will still be far above the average building boom year in the past. We are now creating housing accommodations faster than families are being formed.

2. The marriage rate which was at unusually high levels has now been dropping for the past year, with the probability that it will continue to drift downward. Should economic troubles develop on the horizon, the rate will drop rapidly as it always does during depressions.

3. The migration from the farms to the cities has not stopped but it has slowed very materially. During the next decade it will probably be only slightly faster than the migration from the cities to the farms, leaving a rather small balance in favor of the cities. This was the condition during the depression of the thirties. In other words, it seems to me that the pressure on the housing supply from this source has practically disappeared.

4. It seems reasonable to suppose that construction costs on residential properties are now at the peak, with a strong probability of a drop in the period ahead. The drop has already started in a number of the more important lines of building materials. I think that lumber will drop by a fairly sizable percentage and that many other items during 1949 and 1950 will continue to decline. It also seems probable that the lower volume of residential building will result in some unemployment in the building trades which will increase the efficiency of labor in two ways: 1. The least efficient will be laid off first resulting, on the average, in a higher skilled mechanic. 2. When unemployment becomes a probability the employed work more efficiently in an effort to hold a job which cannot readily be replaced.

5. Interest rates which had been falling until a year or so ago have now shown a slight upward drift with little chance that they will return to the depression lows and with some chance that they might drift still higher. Over a period of years it now seems as if capitalization rates will gradually increase and, if this be the case, the capitalized value of the net income earned by a piece of real estate will be lower than it would otherwise be.

6. The percentage of our urban population living in rented dwelling units is now smaller than it has been at any time in the past. This is due to the fact that under frozen rentals many properties were unprofitable and were sold by the owners to persons formerly tenants who were forced to buy in order to secure shelter. The percentage of tenants in our population will increase slowly from this point out, as many new units have been built without being subject to rent control. As economic difficulties develop, a fairly large percentage of this new housing will become vacant as the housing demand will shrink and, naturally, the portion of the rented dwelling field which is held below its value by Federal rent control will remain solidly rented with all of the vacancies occurring in the uncontrolled and higher-priced units. This will eventually impair the earning power of these newer units and will force some of them through reorganization. If distress property is thrown on a disinterested market as it probably will be, it will further depress values at that time.

7. Every real estate boom has been fed on easy credit. It has been estimated that the Veterans guarantee has so increased the demand for housing that sales prices have risen by the amount of the guarantee, leaving the veteran the doubtful advantage of being able to outbid a civilian for a property priced much above its value. The easy credit period, however, is coming to an end. From one part of the country to another I am hearing the same complaint from real estate men and builders that lending institutions are no longer willing to make heavy percentage loans for a long period of years. The boom was fed by expanding credit; it will probably wither under a credit restriction which will bring back terms and rates which would have been considered quite liberal in most of the booms of the past, but which in comparison with the very loose credit terms we have had during the past few years will seem quite severe.

In addition to all of the foregoing must be added the fact that we have now been in a real estate boom since the middle of 1943. Measured by real estate activity, that is, the number of transfers of real estate to the number of families in principal metropolitan areas, the boom reached its highest point in the spring of 1946, and has been declining at a fairly regular rate since. The peak was 87 per cent above normal; the present position is approximately 22 per cent above normal. If the rate of decline continues, the real boom would be over some time next year with a strong probability of a real estate depression developing in the early and middle fifties. Judged by the real estate booms and depressions of the past, this seems probable.

Our organization is not concerned primarily with the results on the market of our studies and forecasts. We realize that in certain periods our studies can be used by real estate men in selling equities to investors and speculators. In other periods they can be used by real estate brokers in securing listings at reasonable prices. They can always be used by mortgage lenders to determine safe lending policies. Our primary interest, however, is not the optimism or pessimism which these studies might cause. Their function is to accurately portray trends and to estimate probable conditions in the future.

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